



Office of the City Auditor

Use of Additional Tax on Transient Lodging Report No. 0501

December 5, 2005

The additional tax on transient lodging is being used in compliance with City Code and oversight over the use of funds is sufficient; however, establishing a specific special revenue fund would improve documentation and increase accountability.

CITY COUNCIL

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December 5, 2005

To the Most Honorable Mary Manross, Mayor
and Members of the Scottsdale City Council

Transmitted herewith is a report on the Use of the Additional Tax on Transient Lodging, Report No. 0501. We would like to thank Economic Vitality and Financial Services staff for their cooperation and assistance during our audit.

During our audit, we noted several issues that should be considered by City Council. First, we could not determine the correct percentage that should be considered restricted revenues. In 1988, Scottsdale voters approved an increase in the amount collected as an additional tax on transient lodging and set out that a portion (two-thirds) was to be considered restricted. In May 2004, at the recommendation of the Tourism Development Commission (TDC) and Economic Vitality staff, City Council approved Ordinance No. 3576, which changed the allocation from two-thirds to 80 percent. As such, City Tax Code now reflects a percentage that is in conflict with what the voters approved. This creates a perception that the legal restriction is now 80 percent even though this is not what the ballot language specified. We believe that Ordinance No. 3576 should be rescinded to allow the correct percentage to be reflected and then allow, on an annual basis, Council review of the amount of funds contributed from the General Fund to support tourism development activities. This process will maintain the historical record of the vote approved by the citizens.

Second, contractual terms setting out the requirement for matching funds as a condition of receiving funds from the City for improvements at Taliesin West were amended without submitting the change to City Council for approval. The amendment was discussed at a TDC meeting but no contract amendment was formalized.

Although the changes appear to meet the intent of the original agreement, the contract states that "any amendment, modification or variation from the terms of this Agreement shall be in writing and shall be effective only after approval of all parties, or their successors, signing the original Agreement." There was no provision to delegate authority for amendments; therefore, City Council should have approved any change to the contract terms.

Finally, the Economic Vitality Department, charged with the responsibility for carrying out duties related to tourism development, has not been formalized and codified in City Code. As a result, there is no documentation outside budget documents that sets out the purpose of the department, the reporting relationship, or the responsibility to maintain a long-term strategic plan for tourism development. City Code, Section 2-289, sets out that the TDC is to review the City's long-range plan for the tourism industry as well as make recommendations for an ongoing five-year strategic tourism development marketing plan. However, the responsibility for the development of the long-range plan and the five-year strategic plan has not been formally set as a responsibility of a City department so there is no mandated timeframe for annual updates or presentation to the TDC for review and approval.

If you need additional information or have any questions, please contact me at 480-312-7756.

Respectfully submitted,

A handwritten signature in dark ink, reading "Cheryl Lee Barcala". The signature is written in a cursive, flowing style.

Cheryl Barcala, CPA, CIA, CFE, CGFM, CISA, CISSP
City Auditor

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EXECUTIVE SUMMARY

An audit of the use of the additional tax on transient lodging (bed tax) was included on the 2005 Audit Plan for the City Auditor's Office. The goal of this audit is to determine if controls are in place to ensure that the bed tax is used in accordance with City Code. The specific objectives include:

- Determine if adequate controls are in place to ensure that the restricted portion of the additional tax is used in compliance with legal requirements.
- Determine if the program is structured in a manner sufficient to provide assurance that the program purpose will be achieved.

Payments to the Scottsdale Convention and Visitor's Bureau (SCVB) were not included within the scope of this audit as there is a separate contract governing those services. Expenditures under this contract were deemed to be in compliance with the requirements for use of funds.

The scope of our work required us to determine whether or not the City was complying with the legal restrictions on the use of money received from the additional tax on transient lodging. We could not, however, determine the correct percentage that should be considered restricted. In 1988, when the issue was put to the voters, the ballot language stated that two-thirds of the revenue would be used for tourism development. City Tax Code reflected this same language until May 2004 when staff presented a modified ordinance to City Council for approval. As a result of this action, the current ordinance now reads that 80 percent of the revenue is restricted.

With the language presented in the ballot and the current ordinance, we believe there is a conflict between what Scottsdale citizens approved and how the calculation of the restricted portion is now calculated. To complete the work in this audit, we relied on the language in the ordinance and it is with this focus that the findings are presented. Our recommendation to City Council, as outlined in the transmittal letter, is to direct management to rescind modifications to the ordinance to bring it back into compliance with ballot language approved by the voters or to submit the new restriction to a vote.

Our work verified that a formalized process has been developed and criteria established for awarding monies set aside to fund special events. We also found that both the Tourism Development Commission (TDC) as well as the Council approved major expenditures funded with the restricted monies. We found some exceptions that were considered immaterial and not significant enough to include as a reportable condition but were discussed with management. As well, we noted that not all items go to TDC for approval and

there is no policy documenting what items should go to TDC or what are appropriate expenditures.

Major findings included in this report include:

1. We could not verify the beginning carry-forward balance for the restricted funds as controls have not been implemented to track the restricted revenues separate from the unrestricted portion. Because the restricted revenue is tracked in the General Fund and not in a Special Revenue Fund, there is no fund balance reported on financial statements because any excess revenue is closed to the General Fund fund balance. In absence of a Special Revenue Fund, there is no separate record of transfers in and out to maintain a historical record of movements of restricted funds to other funds such as the Capital Improvement Fund when capital projects are completed with monies provided from the restricted bed tax.
2. An "off book" reserve has been created with a portion of the restricted monies generated from the additional tax. At the recommendation of the Financial Services General Manager, TDC approved setting aside \$500,000 of the restricted funds for a cushion against economic downturns. This decision, however, was not submitted to Council for approval and the amount set aside does not show on the City's financial records as a separate reserve. Comprehensive Financial Policies annually adopted by Council do not address this reserve.
3. City Code does not require an allocation of interest earnings when restricted revenues are not completely expended in the year earned. Currently, there is a carry-forward that has been designated as a reserve. Under existing policies established by the Financial Services Department, this reserve does not earn interest. This means that the General Fund earns interest based on the investment of this reserve and this extra revenue is not considered restricted for use towards tourism development.

The Action Plan on the following page outlines our recommendations and summarizes Management's response, which can be found in Appendix A.

ACTION PLAN

No.	Recommendations and Management Response
	Financial Services should:
1	<p>Set up a Special Revenue Fund for the restricted portion of the bed tax monies.</p> <p>Management Response: We concur with the segregation of the restricted portion of the bed tax into a Special Revenue Fund. However, management recommends the use of a cost center within the Special Programs Special Revenue Fund to achieve the outcomes identified in the audit.</p> <p>Responsible Party: Lisa Murphy Accounting Director Completed By: FY 06/07</p>
2	<p>If the reserve is approved by Council, submit a revision to the Comprehensive Financial Policies setting out the reserve and the process that will be used to evaluate the amount held and appropriate use.</p> <p>Management Response: Management does not recommend establishment of any formal or separate reserve from those already maintained. The adopted General Fund Reserve and Contingency Budget are adequate for bed tax expenditure authorization purposes and adding an additional reserve would limit the budgetary options of the City Council.</p> <p>Responsible Party: Craig Clifford, CFO Completed By: N/A</p>
	Economic Vitality should:
1	<p>Submit to Council, for review and approval, modification to City Code to require allocation of interest earnings if there is a carry-forward of restricted revenues and to any reserve balance that may be established.</p> <p>Management Response: Management does not recommend the proposed action. Allocating interest would be inconsistent with the City's 'pooled-cash' management practices where there is no explicit requirement for interest earnings and allocation. The bed tax election ballot and related City Code address only the tax collected and do not address interest allocations.</p> <p>Responsible Party: Craig Clifford, CFO Completed By: N/A</p>
2	<p>Ensure that the budget proposal for tourism is presented to TDC so they can make a recommendation to Council on expenditures as required by City Code.</p> <p>Management Response: We concur. In past years, management has discussed the tourism budget with the TDC and received their input. We will now ask that this input be in the form of a formally adopted recommendation to the City Council.</p> <p>Responsible Party: Dave Roderique Economic Vitality GM Completed By: 04/06</p>

No.	Recommendations and Management Response
3	Ensure that TDC defines criteria for acceptable expenditures, formally adopts policies, and revisits them periodically to update.
	<p>Management Response: We concur. In past years, the TDC has provided guidance for acceptable expenditures. Management will continue to work with them and ask to adopt formal guidelines, which will be reviewed on a regular basis.</p> <p>Responsible Party: Dave Roderique Economic Vitality GM Completed By: 04/06</p>
4	Ensure that the establishment of the reserve is forwarded to Council for review and discussion.
	<p>Management Response: Management does not recommend establishment of any formal or separate reserve from those already maintained (see Financial Services item #2).</p> <p>Responsible Party: Craig Clifford, CFO Completed By: N/A</p>

BACKGROUND

Tourism has been and continues to be important to Scottsdale, bringing approximately 2.5 billion dollars into the local economy annually. Sales tax dollars paid by visitors goes directly into the City's General Fund and helps to reduce the tax burden of local residents. Tourism also supplies approximately 51,000 jobs to Scottsdale.

Bed Tax Ordinance

In 1977, Scottsdale citizens voted to adopt a tax on transient lodging. Because the revenue is generated from the transient rental (defined as a period of not more than 30 consecutive days) of hotel; motel; and resort rooms, the tax is commonly referred to as the bed tax. For many years, the amount taxed was 2 percent of the gross revenue with 1 percent restricted for use in tourism promotion and advertising.

In 1988, the Chamber of Commerce commissioned a consultant to develop an overall hospitality marketing study for a combined geographic area that included the City and the Town of Paradise Valley. To address the proposed strategy, the staff in Planning and Development (the area previously responsible for this program area) proposed a multi-pronged approach:

- Increase the amount charged against transient lodging to 3 percent and modify the allocation so that 2 percent collected would be restricted to tourism related activities.
- Modify the definition of what would qualify as a tourism related activity to include the use of funds for capital projects and a visitor marketing research program.
- Establish a Hospitality Commission and charge this group with the responsibility of reviewing and recommending expenditures associated with destination and event promotion, visitor related capital improvement projects, and visitor research.

Staff presented four specific elements that would be incorporated to make the strategy work. These included:

1. Improve the tracking of the use of the 1 percent of unrestricted revenue to demonstrate that these funds support infrastructure and visually-special projects that are directly attributable to visitors.
2. Increase the amount provided on an annual basis for promotional purposes.
3. Establish a Capital Project Fund to finance visitor-related projects.
4. Establish a Research Program with a variety of research projects.

Because City Charter requires voter approval of any tax over 1 percent, a special election was called in November 1988 to consider the issue. The question was approved and the modifications became effective January 1989. The language adopted as a result of the special election is included in the insert below. The ordinance in its entirety can be found in Appendix B.

...there is hereby levied and shall be collected an additional tax in an amount equal to three (3) percent of the gross income from the business activity of any hotel engaging or continuing within the city in the business of charging for lodging and/or lodging space furnished to any transient. Two thirds of the revenue derived from this additional tax imposed in this section shall be used for hospitality development, including destination and event promotion, visitor related capital projects and visitor research. "Transient" means any person who, for any period of not more than thirty (30) consecutive days, either at his own expense or at the expense of another, obtains lodging or the use of any lodging space in any hotel for which lodging or use of lodging space a charge is made.

The structure outlined in the ordinance continued in effect until May 2004 when City staff presented a proposal to Council to modify the allocation methodology. According to the Council Action Report, TDC recommended that the amount of revenue dedicated to activities that support tourism marketing and development be increased from the mandated two-thirds to 80 percent. This recommendation was made to address the decline in revenue generated from the additional tax.

Staff supported the recommendation with a statement that they believed the intent of calling out a specific allocation methodology when the issue was placed to a vote was to ensure that a minimum amount of revenue from the bed tax was re-invested and that the amount proposed in 1988 was no longer relevant given the current marketplace. Council approved the proposed change and with the adoption of Ordinance No. 3576, 80 percent of the revenue is now considered restricted.

Organization Structure and Budget

Although not codified in City Code, there is an Economic Vitality Department with 11 full-time equivalent (FTE) positions for FY 05/06 and a budget of slightly less than \$8.1 million. The General Manager of this department reports directly to the City Manager. The mission of the work area, according to the FY 05/06 published budget, is:

To position Scottsdale for sustainable, long-term economic vitality in order to enhance the quality of life for all residents.

Four sub-programs fall within the Economic Vitality area of responsibility. These are:

- Economic Development
- Tourism
- Business Services
- Revitalization

Only the Tourism Division will be discussed in this report as the other areas are not involved in the expenditure and oversight of funds raised through the bed tax.

The Tourism Division and Hospitality Development

Hospitality development is the focus of the Tourism Division. The FY 05/06 adopted budget includes the following program description for this work area:

The Tourism Development program is responsible for the economic well-being and quality of life of the community and its residents by strengthening the local tourism industry through a comprehensive tourism development program of tourism research, marketing and promotion, support of special events, and the development of destination attractions and tourism infrastructure.

FY 05/06 program objectives include:

1. Facilitate the mix of product and experience to meet and exceed customer expectations.
2. Expand the City's event support program to better meet changing needs and current trends.
3. Find ways to better explain the value of the tourism industry to the community.

Financial Resources for the Division

For FY 04/05, a little over \$7.9 million was recorded as revenue from the bed tax. Of this, \$6.3 million is restricted (according to current ordinance requirements) and can only be used for specified purposes. According to fiscal year final reports, slightly more than \$5.5 million was charged against the cost center set up to track these restricted expenditures.

The Division also had two assigned full-time staff positions, with a cost of approximately \$139,000 in FY 04/05, funded by the General Fund. In FY 05/06, a third position was added.

Strategic Planning

The Economic Vitality Department developed a 2002-2004 strategic plan that listed the following five goals for the Tourism Division:

- Understand the Market
- Support Special Events
- Develop New Destination Attractions
- Strategically Market and Promote the Community
- Explain the Value of Tourism

While not set out in City Code or defined as a responsibility for the Tourism Division, there is an expectation¹ for an ongoing five-year strategic tourism development marketing plan. The process is currently underway to establish a new five-year strategic tourism development marketing plan for 2005.

The 2000-2004 Tourism Development Marketing Plan incorporated the following areas:

1. A focus on three experience driven market segments:
 - Meetings and Conferences
 - Relaxation, Relief, and Romance
 - Golf Plus
2. Activate with Triggering Cues and Special Events
3. Support with complementary activities and experience:
 - Culture, Arts, Recreation, and Entertainment
 - Desert Environment, Scenery, Ecology, and Adventure
 - Dining and Shopping
4. Apply and overlay new technology:
 - Internet Marketing
 - Database Marketing

Tourism Development Commission

City Code, Section 2-285, outlines the creation of a Tourism Development Commission² to act as an advisory board to the Council on matters

¹ The expectation can be found at SRC, §2-289, where TDC is charged with reviewing long-range plans and making recommendations regarding an ongoing five-year strategic tourism development marketing plan.

² Previously known as the Hospitality Commission.

concerning the expenditure of revenues from the bed tax designated for tourism development.

TDC is composed of seven members including four hoteliers, one member of SCVB, and the remainder from the tourism community. Members are appointed by City Council from SCVB nominations and others that may be filed with the Office of the City Clerk. Terms are three years. Current members are listed in the table below.

Member	Term Ends
Margaret Dunn	09/01/2006
Gerald Gleason	04/03/2006
John Holdsworth	05/01/2007
Thomas Morrow	12/01/2005
Sally Shaffer	12/01/2005
Edward Sickie	07/01/2005
Gordon Zuckerman	05/01/2007

SOURCE: City of Scottsdale Internet site
under Boards & Commissions.

Under City Code, TDC is charged with the review of the proposed use of tourism funds. Based on this review, TDC is to then recommend, to Council, approval; conditional approval; or denial of amount or proposed use.

City Code requires that funds be allocated to the following three program types:

- Convention/Tourism Promotion including promotion of the community as a destination and promotion of specific events. Allocation is to be made in accordance with the adopted strategic marketing plan.
- Visitor Research designed to provide information about visitors for more effective planning and for tourism marketing and development purposes.
- Visitor Related Capital Projects from the balance of funds after the two previous provisions.

Projects receiving an allocation of funding must attract new visitors (measured by increase in room nights), attract visitors year round, or meet other criteria established by TDC.

Administrative duties assigned to TDC include:

- 1) Prescribing the application process to be used to request project approval.
- 2) Establishing the criteria that will be used to evaluate requests.
- 3) Reviewing long-range plans for the tourism industry as proposed by staff and making recommendations regarding an ongoing five-year strategic tourism development marketing plan.

Use of Restricted Funds

Use of the restricted revenues generated from the bed tax falls primarily into three categories with the lion's share funding a long-standing arrangement for promotional activities with SCVB. Remaining marketing funds are used to provide support to events such as the FBR Open, Barrett Jackson Auto Auction, Scottsdale Arabian Horse Show, and the Fiesta Bowl. These events attract significant numbers of visitors and provide valuable exposure to potential visitors through their media coverage.

Scottsdale Convention and Visitor Bureau

To carry out the majority of activities related to convention/tourism promotion, the City has historically contracted with the Chamber of Commerce. This relationship changed in 2001 when a re-structuring effort was undertaken to split off the promotional activities and set up SCVB as a separate entity. Subsequent to this action, the contract has been with SCVB.

The contract defines SCVB's mission as:

- Increasing national and international exposure.
- Attracting new leisure business.
- Responding to customer information requests.
- Increasing convention and meeting bookings through assistance to hoteliers.

SCVB uses six marketing strategies to implement the program which includes advertising, event and consumer promotions, relationship marketing, public relations, website development, and on-line marketing, publications, and promotional materials.

In FY 04/05, the contract with SCVB was \$5,109,120 and in FY 05/06 the amount grew to \$5,659,274.

Event Funding

Each year a specific amount of money is included in the Tourism Development budget to promote events that generate room nights for Scottsdale. In FY 04/05, \$162,156 was authorized by Council for event funding. In FY 05/06, this amount was increased to \$166,907.

TDC develops the criteria that must be met in order to qualify for funding. Beginning in November 2003 through June 2004, TDC revised the program. As a result, the current program was adopted at the June 22, 2004, meeting for implementation of FY 04/05 funds. To qualify, events must:

- Support tourism drivers -- art and culture, culinary, golf, sports and recreation, and western.
- Provide exposure nationally, internationally, or outside Maricopa County and promote Scottsdale's attractiveness as a destination to the target upscale resort visitor.
- Generate room nights in Scottsdale hotels.

Approved uses for matching City funds include:

- SCVB Cooperative advertising program
- Direct mail
- Event placed advertising in SCVB media list entity
- Event placed advertising

Events that meet the qualifying criteria are then evaluated by TDC and any amount awarded must be matched dollar for dollar by the event promoter.

A post event report is required as part of the contract with each participant granted funding.

Fund Accounting

The City uses fund accounting to ensure and demonstrate compliance with finance related legal requirements. Government Accounting and Financial Reporting Principles recommend the use of eight fund types:

- ***The General Fund*** accounts for all financial resources except those required to be accounted for in another fund.
- ***Special Revenue Funds*** account for the proceeds of specific revenue sources that are legally restricted to expenditure for specified purposes.
- ***Capital Project Funds*** account for financial resources to be used for the acquisition or construction of major capital facilities.

- ***Debt Service Funds*** account for the accumulation of resources for and the payment of, general long-term debt principal and interest.
- ***Special Assessment Funds*** account for the financing of public improvements or services deemed to benefit the properties against which special assessments are levied.
- ***Enterprise Funds*** account for operations that are financed and operated in a manner similar to private business enterprises.
- ***Internal Service Funds*** account for the financing of goods or services provided by one department or agency of the government unit to another.
- ***Trust and Agency Funds*** account for assets held by a governmental unit in a trustee capacity.

Accounting for the Bed Tax

Currently, there are two cost centers in the General Fund that are used to track expenditures related to tourism development:

- Hospitality Development - General Fund
- Hospitality Development - Bed Tax

When recording the receipt of the revenue, the entire portion is credited to the cost center Hospitality Development-General Fund. Expenditures considered to be funded with General Fund monies are recorded against this cost center. Expenditures considered to be funded with the restricted portion are recorded in the Hospitality Development-Bed Tax cost center.

Because each of these cost centers are part of the General Fund, any excess or deficit at the end of the year is closed to the fund balance. As such, staff maintains separate records of the carry-forward, any reserves, and transfers to other funds.

SCOPE AND METHODOLOGY

We studied Scottsdale Revised Code, TDC Minutes, and TDC policies to gain an understanding of the requirements associated with the allocation and use of the additional tax on transient lodging. We interviewed Economic Vitality and Financial Services staff to gain an understanding of their respective roles in the allocation, usage, and monitoring of the bed tax. We contacted the City Attorney's Office to discuss the appropriateness of the 2004 bed tax ordinance change. We also reviewed Government Accounting Standards Board (GASB) guidance and City financial policies for appropriate accounting treatment of restricted funds.

Testing was limited to FY 03/04 and FY 04/05 and current procedures with the exception of the carryover balance, which we reviewed the last five completed fiscal years. We specifically excluded the SCVB contract from the review as we considered these expenditures to fall within the required uses and this was not an audit of the SCVB contract.

To test compliance with the allocation of the bed tax, we obtained published sales tax reports and calculated the percentage required by ordinance. We compared this to the amounts posted to the bed tax centers to see if the correct allocation was made. We also compared the allocation to the annual expenditures to determine the amount that was expended and the amount that should be carried over to the next fiscal year.

We traced a sample of expenditures from the detailed trial balance to supporting documentation including event files, vendor contracts, purchasing card logs, check requisitions, invoices, travel claim forms, and mileage reports to determine if all expenditures conform to the purpose defined in City Code. We reviewed the capital project file for the Tourism related project in our audit period to determine if all transactions fell within the scope of work approved by TDC and Council. We reviewed TDC meeting minutes for evidence that TDC:

- Approved all expenditures.
- Established procedures and criteria for how event funds are to be allocated.
- Reviewed the five-year strategic tourism development marketing plan.
- Developed policies that define appropriate use of funds including types of expenditures allowed and purpose of contingency and carryover balances.

We also reviewed specific Council minutes and resolutions for approval for contracts, capital projects, and other bed tax expenditures.

Audit work was conducted in accordance with generally accepted government auditing standards as they relate to expanded scope auditing in a local government environment and as required by Article III, Scottsdale Revised Code, Section 2-117, *et seq.* Survey work took place in July and August and audit testing was done in September and October 2005, with Stella Fusaro and Mary Edmonds conducting the work.

OBJECTIVE 1: DETERMINE IF ADEQUATE CONTROLS ARE IN PLACE TO ENSURE THAT THE RESTRICTED PORTION OF THE ADDITIONAL TAX IS USED IN COMPLIANCE WITH LEGAL REQUIREMENTS.

Finding: Controls are adequate to ensure that expenditures conformed to uses allowed by ordinance, however, the accounting treatment of the restricted funds could be improved to ensure that the bed tax allocation is made in compliance with legal requirements.

Criteria

City Tax Code, Section 447, as currently written, sets the provision for a 3 percent tax on transient lodging. Eighty percent of the revenue is to be used for hospitality development, including destination and event promotion; visitor related capital projects; and visitor research. (The allocation was two-thirds for hospitality development prior to FY 04/05.)

City Code, Chapter 2, Division 5, "Tourism Development Commission," sets out that TDC is to recommend, to Council, approval; conditional approval; or denial of all uses of the restricted revenues. To guide the decisions of TDC, the ordinance also sets out the types of programs to be considered appropriate and the parameters for gauging whether or not a project should be supported (attract new visitors to Scottsdale, as measured by room nights; attract visitor's year round; and other criteria as established by TDC).

The City's Budget Book states that special revenue funds are used to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes. Guidance on GASB Statement 34 states that special revenue funds are to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specific purposes.

Similar restricted revenues generated from privilege taxes, tracked by the City, are accounted for in special revenue funds.

Established City practice has been for interest to be allocated to restricted revenue accounts and internal service funds.

Condition

Expenditures considered to meet the parameters set in City Code for the use of the restricted revenue are tracked in a separate cost center. Based on our review of expenditures recorded in FY 03/04 and FY 04/05, we found that restricted revenues were used for the purpose defined. We did note two exceptions and that certain administrative costs (i.e., taking minutes at TDC meetings) were charged against the restricted revenues that appear to be

more appropriately funded with General Fund monies. Questionable transactions were considered immaterial and discussed with management.

We attempted to verify that the bed tax revenue received as reported by the Tax Audit Division of the Financial Services Department was appropriately recorded as restricted and unrestricted revenue. The restricted portion of the additional tax is tracked in the General Fund rather than in a Special Revenue Fund. As such, there is no separate allocation in financial records. Based on our recalculation of the restricted revenues and comparison of expenditures recorded in the Bed Tax cost center, we determined that expenditures for the last five fiscal years have approximated the portion considered restricted.

Because the restricted revenue is tracked in the General Fund and not in a Special Revenue Fund, we could not verify if there is a fund balance or identify the record of transfers out to other funds. Staff has relied on a manual process to retain this historical record and we were not able to recreate the carry-forward that is currently reported. We obtained the Proforma (the report used by staff to track the restricted portion of revenue and expenditures) and attempted to verify the revenue and expenditures recorded for prior year activity. We could not reconcile the information to sales tax reports and the General Ledger Trial Balance for the appropriate year.

As well, because the restricted revenue is not tracked in a Special Revenue Fund, there is no historical record to document the transfer of funds to other projects tracked in different funds (i.e., the amount transferred to cover the TPC debt service and funds transferred to cover the costs associated with the Taliesin West capital project). As such, we could not verify that records correctly reflect the transfers.

When reviewing the Proforma, we noted that there is no record of interest earnings even though there is a significant carry-forward balance reflected on the report (approximately \$1.5 million at the beginning of FY 04/05³). Without a process to allocate interest earnings for use in carrying out the purpose identified when the tax was approved, the practice of holding a carry-forward balance becomes a revenue generator for the General Fund. This does not appear to be in alignment with the voter approved restriction on use of the funds.

³ At the end of FY 04/05, Financial Services recalculated the FY 04/05 beginning carry-forward balance down to approximately \$900,000. We were unable to verify this balance.

Cause

Accounting decision to track restricted bed tax monies in the General Fund rather than in a Special Revenue Fund.

Practices established by Financial Services Departmental Management to not allocate interest earnings unless there is a specific requirement in City Code.

Effect

Accountability to the citizens approving the restricted revenue and the industry collecting and remitting the tax is hindered. The City would not be able to demonstrate, without effort, that the carry-forward balance is correct; that funds have been spent as set out in City Code; and that investment earnings have been appropriately restricted for future use.

Transfers of restricted revenues are currently tracked at the General Fund level. This effectively obscures the use of the revenue and does not maintain an accurate record of the use.

Recommendation

The Accounting Division should set up a Special Revenue Fund for the restricted portion of the bed tax monies.

The Economic Vitality Department should submit to Council, for review and approval, modification to City Code to require allocation of interest earnings if there is a carry-forward of restricted revenues and to any reserve balance that may be established.

OBJECTIVE 2: DETERMINE IF THE PROGRAM IS STRUCTURED IN A MANNER SUFFICIENT TO PROVIDE ASSURANCE THAT THE PROGRAM PURPOSE WILL BE ACHIEVED.

Finding: The program is structured for adequate oversight; however, strengthening and formalizing existing policies would improve overall accountability.

Criteria

City Code, Section 2-285, sets out a Tourism Development Commission to act as an advisory board to City Council on matters concerning the expenditure of revenues from the bed tax designated for tourism development.

Section 2-288 states that TDC shall recommend to Council for approval, conditional approval, or denial all uses of tourism funds. It requires that funds be allocated to three program types:

- Convention Tourism Promotion
- Visitor Research
- Capital Projects

Tourism funds are to be allocated to projects which meet such other criteria as established by TDC.

Condition

Economic Vitality and Financial Services have done a good job keeping TDC informed of bed tax projections and major expenditures. TDC is made aware of budget items through monthly Proformas discussed at the meetings and the allocation policy presented to them at the annual retreat. TDC and Council have approved major expenditures associated with the bed tax funds including event advertising and the SCVB contract. City Council approves the Tourism budget as part of the City's annual budgeting process. Council has also approved event funding and contracts exceeding the formal procurement limit.

A formalized process has been developed and criteria established for awarding the event funds. TDC has also formally adopted a reserve fund, however, not all items go to TDC for approval nor is there a policy documenting what items should go to TDC and what are appropriate expenditures. Administrative, professional services, and research costs are not specifically brought forth as action items and the budget to be recommended to Council is not presented or approved by TDC as a means of making a recommendation to Council on expenditures.

Cause

Policies have been discussed, but with the exception of the reserve fund, have not been considered an action item for TDC.

Effect

Policies have not been formally adopted and the entire budget has not gone to TDC for recommendation to Council. There has been no formal decision by TDC as to whether administrative expenses should be paid from the bed tax fund and items in the categories of other professional services, postage, graphics, research contracts, and other operational expenditures have not gone to TDC for approval.

TDC has approved the establishment of a reserve without forwarding the proposed use to City Council for approval. There is no provision in City Code to extend this authority to TDC.

Recommendations

Economic Vitality should ensure that:

- The budget proposal for tourism is presented to TDC so they can make a recommendation to Council on expenditures as required by City Code.
- TDC defines criteria for acceptable expenditures, formally adopts policies, and revisits them periodically to update.
- The establishment of the reserve is forwarded to Council for review and discussion.

Financial Services should, if the reserve is approved by Council, submit a revision to the Comprehensive Financial Policies setting out the reserve and the process that will be used to evaluate the amount held and appropriate use.

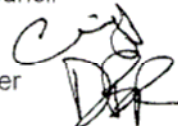
APPENDIX A - MANAGEMENT RESPONSE

MEMORANDUM

December 5, 2005

TO: Cheryl Barcala, City Auditor and Scottsdale City Council

FROM: Craig Clifford, Chief Financial Officer
Dave Roderique, Economic Vitality General Manager



RE: Use of Additional Tax on Transient Lodging Report No. 0501

The attached action plan is in response to Audit No. 0501 relating to Use of Additional Tax on Transient Lodging. Financial Services and Economic Vitality staff have worked together to provide a joint response and a coordinated action plan.

The scope of this audit as defined in the audit's table of contents was to answer two main objectives:

- **Objective 1: Determine if adequate controls are in place to ensure that the restricted portion of the additional tax is used in compliance with legal requirements.**

We appreciate the auditor's comment: "Based on our review of expenditures recorded in FY03/04 and FY04/05, we found that restricted revenues were used for the purpose defined."

- **Objective 2: Determine if the program is structured in a manner sufficient to provide assurance that the program purpose will be achieved.**

Again, we appreciate the auditor's comments: "The program is structured for adequate oversight, however strengthening and formalizing existing policies would improve overall accountability." "Economic Vitality and Financial Services have done a good job keeping the TDC informed of bed tax projections and major expenditures."

Please see the remainder of Management's Response to the specific audit findings and recommendations in the Audit Action Plan. If there are any questions regarding information in the report that is not included in the Audit Action Plan, Management would be pleased to have the opportunity to respond.

C: Jan Dolan, City Manager
Neal Shearer, Assistant City Manager
Lisa Murphy, Accounting Director
Art Rullo, Budget Director
Kathy O'Connor-Carlisle, Tourism Manager

APPENDIX B - ORDINANCE NO. 3576

ORDINANCE NO. 3576

AN ORDINANCE OF THE COUNCIL OF THE CITY OF SCOTTSDALE, MARICOPA COUNTY, ARIZONA, AMENDING SECTION 447, ARTICLE IV, APPENDIX C OF THE SCOTTSDALE REVISED CITY CODE, RELATING TO ALLOCATION OF TRANSIENT LODGING TAXES.

BE IT ORDAINED by the Council of the City of Scottsdale as follows:

Section 1. Section 447, Rental, leasing, and licensing for use of real property: additional tax upon transient lodging, Article IV, Privilege Taxes, Appendix C, Privilege and Excise Taxes, of the Scottsdale Revised Code is hereby amended to read as follows:

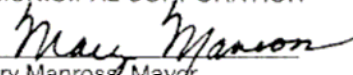
Section 447. Rental, leasing, and licensing for use of real property: additional tax upon transient lodging.

In addition to the taxes levied as provided in section 444, there is hereby levied and shall be collected an additional tax in an amount equal to three (3) percent of the gross income from the business activity of any hotel engaging or continuing within the city in the business of charging for lodging and/or lodging space furnished to any transient. ~~Two-thirds~~ **80 % (EIGHTY PER CENT)** of the revenue derived from this additional tax imposed in this section shall be used for hospitality development, including destination and event promotion, visitor related capital projects and visitor research. "Transient" means any person who, for any period of not more than thirty (30) consecutive days, either at his own expense or at the expense of another, obtains lodging or the use of any lodging space in any hotel for which lodging or use of lodging space a charge is made.


Section 2. If any section, subsection, sentence, clause, phrase or portion of this ordinance or any part of the code adopted herein is for any reason held to be invalid or unconstitutional by the decision of any court of competent jurisdiction, or the ordinance is defeated by referendum, such decision shall cause the wording of Section 447 of Appendix C to the Scottsdale Revised Code to revert back to the form it was prior to the adoption of this Ordinance 3576, to read as if it were never amended by this Ordinance.

PASSED AND ADOPTED by the City Council of the City of Scottsdale, Arizona, this 17th day of May, 2004.

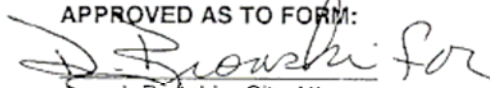
CITY OF SCOTTSDALE
A MUNICIPAL CORPORATION


Mary Manross, Mayor

ATTEST:


Carolyn Jagger, City Clerk

APPROVED AS TO FORM:


Joseph Bertoldo, City Attorney